



The Commonwealth of Massachusetts

**DEPARTMENT OF
TELECOMMUNICATIONS AND ENERGY**

December 2, 2004

D.T.E. 03-127

Petition of Aquarion Water Company of Massachusetts for an accounting deferral regarding expenditures incurred in connection with security initiatives undertaken in response to the events of September 11, 2001.

APPEARANCES:

Thomas G. Tumilty, Esq.
Nixon Peabody, LLP
101 Federal Street
Boston, MA 02110

FOR: AQUARION WATER COMPANY OF
MASSACHUSETTS

Petitioner

I. INTRODUCTION

On September 16, 2003, Aquarion Water Company of Massachusetts (“Aquarion” or “Company”) filed a petition (“Petition”) with the Department of Telecommunications and Energy (“Department”) requesting an accounting deferral regarding expenditures incurred and expected to be incurred in connection with security initiatives undertaken in response to the events of September 11, 2001.¹ Aquarion requests deferral until the Company’s next general rate proceeding of (1) \$314,000 in security-related expenditures actually incurred, (2) \$51,800 in anticipated expenditures relative to the preparation of vulnerability assessments, and (3) an as-yet undetermined amount related to the preparation of emergency response plans (Petition at 2; Exh. DTE 1-3). On December 10, 2003, the Department issued a request for comments from interested persons. No comments were received. The Company has responded to seven information requests issued by the Department.²

II. COMPANY PROPOSAL

Aquarion reports that it has incurred \$314,343 in security-related costs between September 2001 and April 2002, including expenditures for 24-hour surveillance of Company

¹ Approving deferral of an expense allows a company to request recovery for that expense in the company’s next rate case even though that expense was incurred before the test year chosen by the company. See Fitchburg Gas and Electric Light Company, D.T.E. 99-114, at 1 n.3 (2001).

² The Department, on its own motion, moves the Company’s responses to Information Requests DTE 1-1 through DTE 1-6 and DTE 2-1, including supplements, into the evidentiary record in this case. In addition, the Department incorporates by reference the Company’s Annual Returns to the Department for the years 2001 through 2003. 220 C.M.R. § 1.10(3).

facilities and the purchase of assorted security-related equipment (Petition at 1; Exh. DTE 1-5). In addition, the Company anticipates that it will incur additional security-related expenses in the future. Specifically, the Company states that it is required by the Public Health Security and Bioterrorism Response Act of 2001 to conduct an assessment of its vulnerability to terrorist attacks or other acts intended to substantially disrupt the ability of its system to provide a safe and reliable supply of drinking water (Petition at 1; Exh. DTE 1-3).³ The Company states that it is required to provide this assessment to the Environmental Protection Agency (“EPA”) (Exh. DTE 1-4). Aquarion estimates the cost of the vulnerability assessment to be \$51,800 (Exh. DTE 1-3).⁴ Aquarion further states that emergency response plans based upon the results of the vulnerability assessment must be filed with the EPA by December 31, 2004 (Petition at 1). The Company seeks to defer the \$314,000 in security-related expenditures actually incurred, as well as the approximate \$51,800 in future costs related to the preparation of vulnerability assessments and the as-yet undetermined cost associated with preparing its emergency response plans (Petition at 1-2).

Regarding the actual security-related expenses incurred, the Company has booked the \$314,000 in expenses incurred during 2001 and 2002 to Account 218 (Other Unadjusted Debits), which is a deferred account (2002 Annual Return to the Department at 203). Aquarion contends that, absent approval of an accounting deferral, the Company will be

³ 42 U.S.C. §§ 1433(a); 42 U.S.C. §§ 1433(b).

⁴ The Company states that no federal grant money has as yet been authorized for companies of Aquarion’s size to conduct the required vulnerability assessments (Petition at 1).

obligated to write off the \$314,000 against expenses, thereby significantly affecting earnings for that year through a reduction in after-tax utility operating income of approximately \$188,000 (or over 14 percent) (Exh. DTE 1-6).⁵

With respect to the actual security-related expenses incurred as well as the anticipated future costs, the Company argues that the actions to protect the system, facilities, employees, and customers are prudent and necessary in order to address the threat of terrorist attacks (Petition at 1). Aquarion argues that it is in the public interest to implement ongoing measures to protect the integrity of the Company's infrastructure (Exh. DTE 1-6). The Company claims that it is reasonable to expect that these costs will be borne by ratepayers because they receive the benefits of greater safety and reliability of service (Petition at 2).

III. STANDARD OF REVIEW

The Department formulated its standard for reviewing requests for deferral accounting treatment in North Attleboro Gas Company, D.P.U. 93-229 (1994). In that case, the Department stated that a utility seeking deferral treatment must demonstrate prima facie in its petition that: (1) based on Department precedent, the annual expense may be recoverable as an extraordinary expense if it were incurred during a test year;⁶ (2) a Department denial of the request for deferral would significantly harm the overall financial condition of the company;

⁵ The reduction in after-tax utility operating income of approximately \$188,000 is derived by multiplying the \$314,000 in expenses by 60 percent to account for income tax effects (Exh. DTE 1-6).

⁶ For example, the company's request for deferral would be evaluated in terms of what would constitute an annualized amount. D.P.U. 93-229, at 7 n.9.

and (3) the Department's denial of the request for deferral is likely to cause the filing of a rate case that would include in its test year the expense for which deferral is sought ("North Attleboro standard"). Id. at 7.

The Department's review of a complete petition must strike a balance between historical ratemaking principles which employ the test year method to determine a representative level of expenses, and administrative efficiency which might be achieved by avoiding either single-issue rate cases or rate cases precipitated by an extraordinary expense which may be recoverable if incurred in a test year. Thus, once a prima facie showing is made, the Department will evaluate the petition, considering such additional factors as: (1) the company's ability to choose a test year; (2) the company's history and frequency of rate increases; (3) the company's frequency of requests for deferral; (4) the company's earnings in the year the subject expense was incurred; and (5) whether some voluntary agreement on the part of the petitioner (e.g., a settlement) would otherwise preclude bringing a G.L. c. 164, § 94 petition during the period for which deferral is sought. Id. at 7-8. Granting a deferral pursuant to this standard would not constitute a guarantee that the subject expense would be recoverable in a future rate case. Rather, subsequent ratemaking treatment of the expense would be considered in the company's next rate case. Id. at 8.

IV. ANALYSIS AND FINDINGS

Utilities may not typically recover through rates any expenses that were incurred prior to the test year. Otherwise, a company making adequate earnings during a particular year could "bank" its expenses to a deferred account and collect them in a future rate case.

Commonwealth Electric Company, D.P.U. 88-135/151, at 28-29 (1989); see Oxford Water Company, D.P.U. 88-171, at 29-30 (1989). If certain conditions are met, however, the Department may allow a company to defer accounting treatment of expenses incurred prior to the test year and will consider the subsequent ratemaking treatment of those expenses in the company's next rate case. See D.P.U. 93-229, at 7-8.

In the present case, Aquarion seeks to defer three categories of costs related to enhanced security initiatives undertaken in response to the events of September 11, 2001: (1) \$314,343 in costs actually incurred during 2001 and 2002; (2) an estimated \$51,800 representing costs to conduct future vulnerability assessments; and (3) an as-yet undetermined amount associated with the preparation of emergency plans that must be completed not later than six months after completion of the vulnerability assessments (42 U.S.C. §§ 1433 et seq.). As an initial matter, the Department must consider which of these expenditures are eligible for deferral consideration.

With respect to the security-related costs actually incurred, the Company had \$135,578 in security-related expenditures during 2001, and \$178,765 during 2002, for a total of \$314,343 (2002 Annual Return at 203). Of this amount, \$146,310 is for Company payroll expenses associated with ensuring direct after-hours calls capability during the period from September 2001 through April 2002 (Petition at 1; Exh. DTE 1-5).⁷ Another \$143,003 accounts for payments to the Towns of Hingham and Hull for 24-hour police patrol services

⁷ Normally, after-hours calls are routed to a contracted answering service. For a number of months after September 11, 2001, after-hours calls were temporarily taken directly at the Company's Hingham water treatment plant (Petition at 1; Exh. DTE 2-1).

around Company facilities during the same period (Exh. DTE 1-5).⁸ The remaining \$25,030 is for vendor payments for alarms, motion detectors, gates, fencing, and other infrastructure hardware put in place after September 11, 2001 (Exh. DTE 1-5).

Under the Uniform System of Accounts for Water Companies (“USOA-Water”), 220 C.M.R. § 52.00 et seq., the payments made for after-hour call capabilities and 24-hour police patrols are operating expenses and, therefore, are eligible for deferral consideration. However, based on the Company’s description of the \$25,030 in vendor payments, these expenditures are for plant additions that should be booked to plant accounts in accordance with the USOA-Water and, therefore, are capitalizable.⁹ Assabet Water Company, D.P.U. 95-92, at 6-7 (1996). The costs associated with capitalizable items are recovered through a combination of depreciation expense and a return on the undepreciated balance. Hingham Water Company, D.P.U. 1590, at 22-23 (1984). The North Attleboro standard pertains to the deferral of extraordinary expenses; there is no basis on which capitalizable items that have been placed into service may be accorded deferred accounting treatment. D.P.U. 92-239, at 7-8. Therefore, capitalized items are not eligible for deferral. Cambridge Electric Light Company/Commonwealth Electric Company, D.T.E. 99-90-C at 21 (2001). Accordingly, the Company’s request to defer \$25,030 in plant additions must be denied.

⁸ The Company states that it is no longer incurring any direct expenses relative to police patrols (Exh. DTE 2-1). Rather, these patrols are now conducted as part of the local police departments’ day-to-day operations (id.).

⁹ Most of these expenses should be booked to Account 104 (Structures).

With respect to the remaining \$289,313 in security-related expenditures actually incurred, and that can be considered for deferral under Department precedent, the North Attleboro standard does not restrict deferrals to expenses that occur in a single calendar year.¹⁰ D.T.E. 99-114, at 5-6; see D.T.E. 93-229, at 7 n.9. However, the Company's request for deferral must be evaluated in terms of what would constitute an annualized amount. D.T.E. 99-114, at 6; D.T.E. 93-229, at 7 n.9. The expenses that are eligible for deferral consideration were incurred by Aquarion over a period of approximately eight months (i.e., September 2001 through April 2002). In view of the eight-month period of time over which Aquarion had incurred these security-related costs, as well as the fact that these costs are not continuing, the Department finds that an appropriate annualized amount is equal to the total incurred cost of \$289,313.

Once an annual expense is established, the Department next considers whether the expense meets the first part of the North Attleboro standard -- namely whether the expense may be recoverable as a nonrecurring expense if it was incurred during a test year. Based upon the Company's description of the expenses at issue, these security-related costs represent nonrecurring expenses. Nonrecurring expenses incurred in the test year are ineligible for inclusion in the cost of service unless it is demonstrated that they are extraordinary in nature and amount as to warrant their collection by amortizing them over a period of time. Fitchburg

¹⁰ Deducting the \$25,030 in vendor payments from the total \$314,343 in security-related expenditures actually incurred produces a revised actual expense level of \$289,313.

Gas and Electric Light Company, D.T.E. 99-115, at 5 (2001); Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 33 (1983).

With respect to the nature of the expenses at issue, safe and clean water is essential to our basic well being. Water companies are required to deliver a safe and reliable water supply. See e.g., South Egremont Water Company, D.P.U. 95-119/122, at 10-11 (1996); Dedham Water Company, D.P.U. 85-188, at 9-10 (1986); G.L. c. 111, § 5G. However, the challenge of providing a safe and reliable supply of drinking water has expanded greatly after September 11, 2001.¹¹ A terrorist attack directed at the water supply could disrupt the delivery of this essential service, threatening public health. As Congress has recognized through the enactment of the Public Health Security and Bioterrorism Response Act of 2001, all water companies must now take a broader view of water safety and security. The expenses at issue are directly related to Aquarion's compliance with the Public Health Security and Bioterrorism Response Act of 2001 (to conduct an assessment of its vulnerability to terrorist attacks and to develop emergency response plans based upon the results of the vulnerability assessment). Accordingly, we find that the expenses at issue are extraordinary in nature.

¹¹ However, as early as 1941, Federal Bureau of Investigation director J. Edgar Hoover recognized "that among public utilities, water supply facilities offer a particularly vulnerable point of attack to the foreign agent, due to the strategic position they occupy in keeping the wheels of industry turning and in preserving the health and morale of the American populace" (Hoover, J.E., *Water Supply Facilities and National Defense*, 1941. *Jour. American Water Works Association*, 33:11:1861).

With respect to the amount of the expenses at issue, Aquarion argues that the expense is significant because it results in a write-down of about 14 percent of common equity.¹²

However, total operating revenues are the standard for comparison to determine eligibility for deferral accounting, not a subset of revenues (i.e., net income) or balance sheet entries (i.e., common equity). D.P.U. 93-229, at 7; see also Boston Gas Company, D.T.E. 03-40, at 30 (2003); Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 80-81 (2002).

The Company's operating revenues during calendar year 2003 were \$12,057,442 (2003 Annual Return at 302). In the current economic climate, we are persuaded that a one-time expense of \$289,313 for a small water company with revenues of approximately \$12 million is extraordinary in amount. Having found that the \$289,313 in expenses is sufficiently extraordinary in nature and amount to be eligible for recovery as a nonrecurring expense if it were incurred during a test year, Aquarion's request satisfies the first part of the North Attleboro standard.

The Department must next consider whether a denial of the deferral request would significantly harm the overall financial condition of the Company. Based on the Company's net income available for common dividends and common equity balance,¹³ Aquarion's return

¹² Adjusting the Company's calculation to remove \$25,030 in plant additions that are ineligible for deferral consideration, the actual security-related expense of \$289,313 would have an after-tax effect of approximately \$173,600, representing a reduction in net utility operating income of approximately 12.9 percent.

¹³ A water company's common equity consists of common stock, premium on common stock, retained earnings, and surplus invested in plant. 220 C.M.R. § 31.01; see also Aquarion Water Company of Massachusetts, D.T.E. 02-57, at 5 (2002).

on equity (“ROE”) during 2001 was 8.53 percent (2001 Annual Return to the Department at 201, 301). The Company’s ROE declined to negative 5.52 percent in 2002 and then increased to 13.92 percent in 2003 (2002 Annual Return to the Department at 201, 301; 2003 Annual Return to the Department at 201, 301). Although the Company’s 13.92 percent ROE in 2003 is in excess of the 11.5 percent ROE approved by the Department in Massachusetts-American Water Company, D.T.E. 00-105, at 3 (2001), a single year of financial results provides an insufficient basis for determining a particular company’s future earnings. Eastern-Essex Acquisition, D.T.E. 98-27, at 18 (1998). This is especially true in the case of a small investor-owned water utility, where a single unplanned event may drastically affect the company’s operations and financial performance for that year. Consequently, water companies, in general, experience greater earnings volatility than other regulated utilities. Generic Cost of Capital for Water Companies, D.P.U. 96-90-A at 8 (1997). Therefore, we find that denial of Aquarion’s request to defer \$289,313 in security-related expenses would significantly harm the overall financial condition the Company. Accordingly, Aquarion’s request meets the second part of the North Attleboro standard.

Turning to the third part of the North Attleboro standard, whether denial of the petition would trigger a rate case filing, history shows that the Company has filed rate cases approximately once every five years. See e.g., Massachusetts-American Water Company, D.T.E. 00-105, at 1 (2001); Massachusetts-American Water Company, D.T.E. 95-118, at 1 (1996); Massachusetts-American Water Company, D.T.E. 90-146, at 1 (1990). While past rate-filing practices by a particular company do not predetermine future conduct, Aquarion,

like other water companies, is faced with significant capital expenditures required to ensure compliance with the Safe Drinking Water Act.¹⁴ 42 U.S.C. §§ 300f et seq.. In addition, as a small water company serving a primarily residential customer base, Aquarion has limited growth opportunities through additional sales. Therefore, we conclude that denial of the petition would likely trigger the filing of a rate case by Aquarion.

Having met the prima facie requirements of the North Attleboro standard, Aquarion's request to defer \$289,313 in security-related expenses must be evaluated considering such additional factors as Aquarion's ability to choose a test year, the history and frequency of Company rate increases, the frequency of Company requests for deferral, the Company's earnings in the year the subject expense was incurred, and whether some voluntary agreement precluded the Company from bringing a G.L. c. 164, § 94 petition during the period for which deferral is sought. D.P.U. 93-229, at 7-8. As noted above, history indicates that the Company files a rate case approximately once every five years and had an operating loss during the year that the security-related expenditures were incurred. A review of the settlement agreement in Company's most recent rate case, D.T.E. 00-105, indicates that the Company is not under any restrictions regarding either the date to file a future rate case or the test year to be used. Finally, Aquarion (or its predecessor) has only sought two other accounting deferrals in the last ten years, both related to pension and post-retirement benefits other than pension expense. Massachusetts-American Water Company, D.P.U. 92-239 (1993);

¹⁴ See e.g., Aquarion's recent construction of a water treatment facility in its Millbury service territory. D.T.E. 02-57, at 1-2.

Aquarion Water Company of Massachusetts, D.T.E. 03-91 (2003) (pension and PBOP expense) (Exh. DTE 1-1).

Taking the above factors into consideration in conjunction with Aquarion's prima facie showing, the Department finds that the Company has met the requirements of the North Attleboro standard. Therefore, Aquarion's request to defer \$289,313 in security-related expenses actually incurred is granted. Granting this deferral does not constitute a guarantee that this expense will be recoverable in a future rate case. Rather, the Department will consider the subsequent ratemaking treatment of the expense as part of the Company's next rate case.

Turning to the Company's request to defer projected security-related expenditures, Aquarion anticipates that the vulnerability assessments will cost approximately \$51,800, with an as-yet undetermined amount for the preparation of emergency plans (Exh. DTE 1-3). The North Attleboro standard does not provide for the deferral of future expenses, even if an estimate of the expense is available. Moreover, an estimate of the expenses relative to the future preparation of emergency plans are not presently known and cannot be established until the vulnerability assessments have been prepared and studied. Depending upon the results of the vulnerability assessment, the preparation of emergency plans may be a relatively straight-forward process or may require a considerable expenditure on the part of Aquarion. Therefore, there is currently no basis on which to establish the scope of the work required, much less determine an annualized expense level or assess whether the annual expense would be recoverable as a nonrecurring expense if it were incurred during a test year. Therefore, the

Department finds that Aquarion's request for deferral of future expenditures related to the preparation of vulnerability assessments and emergency plans is premature. Accordingly, the Department denies, without prejudice, the Company's request to defer the cost associated with vulnerability assessments and emergency plans.

V. ORDER

Accordingly, after notice and consideration, it is

ORDERED: That the petition of Aquarion Water Company of Massachusetts for an accounting deferral regarding \$289,313 in security-related expenditures actually incurred is GRANTED; and it is

FURTHER ORDERED: That the petition of Aquarion Water Company of Massachusetts for an accounting deferral regarding projected security-related expenditures is DENIED without prejudice.

By Order of the Department,

/s/

Paul G. Afonso, Chairman

/s/

James Connelly, Commissioner

/s/

W. Robert Keating, Commissioner

/s/

Eugene J. Sullivan, Jr., Commissioner

/s/

Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within 20 days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of 20 days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).